

**OPPORTUNITIES AND OPTIONS FOR  
LOCAL GOVERNMENT CREDIT  
FACILITY AND POOLED FINANCE  
MODELS FOR LOCAL GOVERNMENT  
IN THE CZECH REPUBLIC**

Prepared by

Robert O. Lenna  
Maine Municipal Bond Bank

The Urban Institute  
2100 M Street, NW  
Washington, DC 20037

UI Project 06283-135  
December 1996

Prepared for

INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION  
Local Government and Housing Privatization  
USAID Project No. 180-0034  
U.S. Agency for International Development, ENI/EEUD/UDH  
Contract No. EUR-0034-C-00-2034-00, RFS No. 135

## **OPPORTUNITIES AND OPTIONS FOR LOCAL GOVERNMENT CREDIT FACILITY AND POOLED FINANCE MODELS FOR LOCAL GOVERNMENT IN THE CZECH REPUBLIC**

This report reflects information gathered during a trip to Prague in the Czech Republic from December 3 to December 10, 1996. The trip and meetings with various state and local governmental personnel and private banking institutions were all arranged by the Urban Institute (UI) and the United States Agency for International Development (USAID).

The purpose of the trip was to determine if (a) there was interest at the National and Local level in pursuing ways in which to provide access to capital for local governments through some type of local government credit facility (b) to see if any of the financial models and institutional tools developed in the United States Municipal Bond market might be able to be applied by local Czech governments and (c) to talk specifically about the concept of "pooling" of small municipal borrowers through a mechanism like a Bond Bank as it has evolved in the U.S. over the last thirty years. An additional goal was to determine if there were actions that could be taken in the near term to assist in the development of the Czech local government credit market particularly in regard to the development of a pooled financing mechanism.

Over the course of four days (December 4, 5, 6, and 9) meetings were held at the Deputy Minister level with the Ministry of Finance, the Ministry of Local Government (a successor Ministry to the former Economic Ministry), the Czech National Bank (the equivalent to the United States Federal Reserve), and two mayors representing the national Union of Towns and Communities (the equivalent to the U.S. Conference of Mayors). In the private sector meetings were held with two Czech commercial banks and with CS First Boston which maintains an office in Prague. All of the meetings with State Ministries, except the Czech National Bank, and with Czech Commercial Banks included attendance and participation by representatives of the USAID office in Prague. A brief close out phone call on 12/9/96 was held with Mr. Posner of the USAID office.

### **FINDINGS**

1. All the parties interviewed agreed that local government in the Czech Republic, particularly the approximately 6200 local towns which contain about twenty percent of the country's population, face enormous difficulty in raising capital for infrastructure. As noted at the meeting with the Czech National Bank, the availability of capital in general, after an initial major inflow after 1989, continues to be a problem. While there has been some success with a limited number of local bond issues from among the 150 larger communities, including Prague, and the Czech Savings Bank (which unfortunately was not available for a meeting during the trip) has made several direct loans to communities, the overall availability of capital for municipal finance remains thin. As is true in most thin markets the available term and rates for borrowing tend to be onerous, with comparatively high real interest costs and comparatively short term.

2. With the exception of the Ministry of Finance, there was a genuine enthusiasm for looking for solutions for the local capital access problems. The Ministry of Local Development and the two private banking institutions (Czech and Moravian Guarantee and Development Bank and the First Municipal Bank) were particularly strong in their interest as were the two mayors from the Union of Towns and Cities. The comparative lack of enthusiasm from the Ministry of Finance was not explained by the Deputy Minister with whom we met. Despite the lower level of interest in the problem the Ministry of Finance indicated that they at least would not oppose activities designed to try and help define and address the problem.

3. There are substantive mechanical impediments to the development of a functioning local government credit facility, whether based entirely on the internal capital markets or moved into the European market. Current audit standards and financial information standards would need to be strengthened. The ability to pledge cash flows from the central government to the local government would need to be clarified. (In this regard the role of the Czech Savings Bank which apparently acts as the central government's transfer payments system to local governments would need clarification) Ideally some form of locally controlled local taxing power, other than the limited fees currently controlled by the local governments, would be made available. The local credit market needs to move from an asset lending model to a cash flow lending model for local governments. The role of the Regions as proposed to be created in the Constitution needs to be clarified.

4. Even with these impediments there are strong reasons to proceed in efforts to establish local government credit facilities both within the Czech capital market and the European market. The need is clearly large. There appears to be a consensus that the issue is worth addressing. Local government's themselves seem particularly interested in the availability of a credit facility. The two local banks both expressed strong interest in taking the role of the local government credit facility. One has done guarantee work in local governments in the area of housing and the other says that it is in the middle of putting together a pooled municipal bond sale with twenty four towns. Czech law gives towns great latitude to work together in joint activities. Although small in the number of communities participating the existence of some outstanding municipal bonds and loans provides the start of a track record for the market. The Czech Republic is focused on obtaining its entry to the European Union in 2004 or sooner and to the extent that institutional systems are in place when such entry is achieved, even if they have not been used by great numbers of towns, it will allow for a rapid movement into the general access to the European credit markets that membership in the EU will immediately provide.

5. The issue of whether to attempt to develop an internal local government credit facility, an internal municipal bond market or either of those structures for local governments from the Czech Republic in the European markets (regardless of currency) should not be allowed to become a distraction to proceeding with creating the institutional frameworks for local government credit facilities. A pooled financing mechanism for local governments could work in any of those markets. The Ministry of Finance and some others expressed doubt as to whether or not local investors would purchase local government bonds either individually or in a pool, but in a real sense this issue is beside the point. The process of developing the frameworks for getting local governments access to capital markets must include the participation of not just the issuers, but also the potential buyers, letter of credit providers, underwriters, lenders, accountants and lawyers. A functioning municipal credit facility, regardless of which credit market it is accessing, needs the understanding of all these participants. Particularly if we are attempting to transfer some of the U.S. municipal market credit enhancement and credit homogenizing features to the European or Czech markets all these people need to be "brought upto speed" on why and how these financial mechanisms work.

6. The use of a pooled financing mechanism for Czech local governments would provide a way for many local governments to obtain the same benefits such pooling operations have generated in the U.S., i.e. cost of issuance savings, credit dispersal benefits, access to



sophisticated financial knowledge for infrequent small issuers, and the format to allow for external forms of credit homogenization. For the hundreds of very small communities the borrowing model of Administrative Districts for specific activities such as Schools, Hospitals, Wastewater and Drinking Water facilities which has also been used successfully in rural states in the U.S. would also need to be used. Such "associations" as they are called in Czech municipal government are allowed in Czech law and at least one has already been created for a Wastewater system. For such high capital cost activities it appears that most Czech communities, certainly those with populations less than 1,000 people, do not have the current cash flow or the ability to generate tax or other revenue that would be needed as cash flow in order to pay off bonds.

## **RECOMMENDATIONS**

1. The mayors representing the Union of Towns and Cities offered to organize their next quarterly meeting of their small cities sub-committee around the issue of creating a pooling mechanism of local governments to assist in the development of a local government credit facility and a Czech municipal bond market. The mayors said that they thought the next session of the small town sub-committee could be scheduled around the end of February 1997. A seminar on pooled financing for local governments and the development of some form of local government credit facility could be the center piece of the event. The mayors suggested a step by step process review of how such a local government pool works in the U.S. and a discussion and determination of any actions that might need to be taken by the National government to directly assist or facilitate such a pooled finance concept be a part of the seminar. The Ministry of Local Government also expressed strong interest in such a seminar. It might be possible to have a joint sponsorship of the seminar as part of the next Union Small Town sub-committee session. If such an event is to take place contact would need to be made immediately with the Union of Towns and Cities and/or with the Ministry for Local Development. The politics of whether these two entities could sponsor this seminar jointly or who should be asked first to sponsor it are beyond my knowledge.

The seminar should be used as a tool to educate not only the local government officials on the ideas of municipal finance and pooled financing in particular, but also to bring together the local officials with the other professionals required to make the market work. Buyers of previous Czech issue bond sales should be invited. Letter of Credit provider banks from around Europe should be invited. Several major accounting firms have local offices in Prague and they should be encouraged to come. These other professionals need to learn about pooled municipal finance as it has worked in the U.S. and they also should meet and get to know local Czech officials.

## **OTHER ISSUES TO BE PURSUED**

1. The form of the umbrella issuer or lender for the pooled local government model. Can or should an existing commercial bank like the Guarantee Bank do this? Should a new more closely governmental related entity, perhaps through the Ministry for Local Development, undertake the role of the umbrella (Bond Bank) issuer of bonds or maker of loans be created?:

2. Will the National government undertake even a minimal effort to homogenize the local government credit through the use of a moral obligation make up provision of a Reserve Fund

model for loans or bonds? Will European banks provide a letter credit to fund a reserve fund with or without the National government make up provision? Would the National government purchase such LOC's for local government pooled issues as their contribution.

3. Will local governments create project specific associations (in the U.S. often thought of as governmental districts such as Water Districts or Sewer Districts) to become the borrowing entity to deal with the issue of communities of 1000 or less with no assets, no tax base, no fee base, but with infrastructure needs?

4. The national government currently has grant and loan programs in place for environmental infrastructure and schools. Consideration may want to be given to converting at least the grant portion of those programs to the creation of permanent revolving loan funds to provide credit enhancement and interest write downs for local debt. The model of the State Revolving Loan Funds for Wastewater and Drinking Water as they have been developed in the U.S. could be looked to as a way in which to accomplish this. The benefits would be to create a long term source for financing in specific areas and have funds available that could be used as cash in reserve funds for local issues of debt or to purchase letters of credit or bond insurance for sales in the European or Czech credit markets.

These issues along with some of the issues raised by the impediments noted in the Findings section all could be topics for the seminar.

## **CONCLUSION**

There is an opportunity to assist in the development of a critically needed local government credit facility in the Czech Republic. A significant first step can be taken with a seminar on the issue accessible to all the participants in such a market. Markets operate and are based on knowledge. The development of knowledge about the forms a municipal credit facility in the Czech Republic might take would be an important early step in the development of a municipal credit market that is sure to come. Knowledge can help it come sooner, make it operate more efficiently, and help local Czech government obtain access to affordable capital for the critical work they have challenged themselves to accomplish in the rebuilding and revitalization of their infrastructure and their environment.